2010 REGULAR SESSION
ACTUARIAL NOTE HB 458

House Bill 458 HLS 10RS-596 Engrossed **Author:** **Representative Jeffery J. Arnold** **Date: June 7, 2010** **LLA Note HB 458.02** **Organizations Affected:** **Firefighters' Pension and Relief Fund in the City of New Orleans** **EG +$800,000 FC LF EX**	**The Note was prepared by the Actuarial Services Department of the Office of the Legislative Auditor.** David K. Greer **David K. Greer, CPA** **Assistant Legislative Auditor and** **Director of Performance Audit** **and Actuarial Services**

<u>Bill Header:</u> RETIREMENT/LOCAL: Provides for the option of a 10-year DROP for members of the Firefighters' Pension and Relief Fund in the city of New Orleans (NOFF).

<u>Cost Summary:</u>

Actuarial Cost/(Savings) to Retirement Systems and OGB	$10,700,000
Total Five Year Fiscal Cost	
Expenditures	$8,000,000
Revenues	$4,000,000

<u>Estimated Actuarial Impact:</u>

The chart below shows the estimated increase/(decrease) in the actuarial value of benefits, if any, attributable to the proposed legislation. Note: it includes the present value cost of fiscal costs associated with benefit changes. It does **<u>not</u>** include present value costs associated with other fiscal concerns.

Actuarial Cost (Savings) to:	Increase (Decrease) in The Actuarial Present Value
All Louisiana public retirement systems	$10,700,000
Other Post Retirement Benefits	$0
Total	$10,700,000

<u>Estimated Fiscal Impact:</u>

The chart below shows the estimated fiscal impact of the proposed legislation. This represents the effect on cash flows for government entities including the retirement systems and the Office of Group Benefits, as well as other fiscal concerns.

EXPENDITURES	2010-11	2011-12	2012-13	2013-14	2014-15	5 Year Total
State General Fund	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Agy Self Generated	800,000	800,000	800,000	800,000	800,000	4,000,000
Stat Deds/Other	0	0	0	0	0	0
Federal Funds	0	0	0	0	0	0
Local Funds	800,000	800,000	800,000	800,000	800,000	4,000,000
Annual Total	$ 1,600,000	$ 1,600,000	$ 1,600,000	$ 1,600,000	$ 1,600,000	$ 8,000,000

REVENUES	2010-11	2011-12	2012-13	2013-14	2014-15	5 Year Total
State General Fund	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Agy Self Generated	800,000	800,000	800,000	800,000	800,000	4,000,000
Stat Deds/Other	0	0	0	0	0	0
Federal Funds	0	0	0	0	0	0
Local Funds	0	0	0	0	0	0
Annual Total	$ 800,000	$ 800,000	$ 800,000	$ 800,000	$ 800,000	$ 4,000,000

<u>Bill Information:</u>

Current Law

Current law contains a 5-year DROP provision and a 5-year Retro-DROP provision for the Firefighters' Pension and Relief Fund for the city of New Orleans.

Under DROP provisions a member may elect to enter DROP when he first attains normal retirement age or at any date thereafter. He may enter DROP only once. If he elects to enter DROP, then:

1. The member's retirement benefit is calculated as of the date he enters DROP. This amount is deposited monthly into the member's DROP account.

2. The member does not contribute to the retirement system once he has attained normal retirement age. Therefore, a member's decision to participate or not participate in DROP has no bearing on employee contributions to the plan.

3. Employer contributions to the retirement system are discontinued while the member is in DROP.

4. The member does not accrue benefits while in DROP.

5. DROP accounts do not earn interest while the member participates in DROP.

6. The maximum period of time to be in DROP is 5 years.

If the member continues to work after the DROP period:

1. The member's employer contributes to the plan.

2. The member accrues service credits toward a supplemental retirement benefit.

3. The member's DROP account balance earns interest at the actuarial rate of return less 2.0%.

Under Retro-DROP provisions, a member who has attained normal retirement age and has at least 12 years of service may at any time thereafter retroactively enter DROP up until he actually terminates employment. The following provisions apply to a member who retroactively enters DROP.

1. The member may select the duration of the Retro-DROP period to a maximum of 5 years.

2. Benefits accrued during the Retro-DROP period are forfeited.

3. If a member continues to work after electing Retro-DROP, the member's employer will contribute to the plan and the member will accrue supplemental benefits based on service and salary credits earned after electing Retro-DROP.

A member who enters DROP may later elect to also participate in Retro-DROP and over ride his original DROP decision.

Proposed Law

The DROP and Retro-DROP provisions under current law are retained except that the maximum DROP and Retro-DROP participation periods are changed from 5 years to 10 years.

Implications of the Proposed Changes

Under HB 458, the number of years that a member of the Firefighters' Pension and Relief Fund in the City of New Orleans can simultaneously work and collect a pension will be doubled from 5 years to 10 years. It also gives the member a longer period of time to retroactively correct an earlier decision about entering DROP if such a decision had turned out to be unfavorable.

Cost Analysis

Analysis of Actuarial Costs

Retirement Systems

DROP provisions in Louisiana public retirement plans vary widely from plan to plan. Although DROP provisions for each plan are unique, they can be generally categorized as follows:

1. Traditional DROP

   Traditional DROP plans require a plan member to make an election to enter DROP when he first attains normal retirement age. The DROP period is specified as 5 years, during which time the member continues to work, he does not contribute to the plan, his employer does not contribute to the plan, he does not accrue additional benefits, and his retirement benefit is placed in his DROP account which will be paid out when he eventually retires.

   A plan member electing DROP believes that his future will be such that he will be better off participating in DROP than not participating. However, life circumstance can change significantly in 5 years particularly for a person who is at retirement age or older. At the end of the DROP period, it can be determined whether the member made a "good" decision or a "bad" one. The historical pattern is that some members win by participating in DROP while others lose. Over the course of time, it can be demonstrated that traditional DROP provisions are actuarially neutral in the aggregate – that is, the winners offset the losers and employers or other contributors to the plan do not subsidize the program.

   The Traditional DROP program under the Firefighters' Retirement System is somewhat more generous than most Traditional DROP programs because it does not require a member to elect DROP when first eligible for retirement, but rather, allows a member to enter DROP at any time after becoming retirement eligible.

2. Back-DROP

   Back-DROP provisions eliminate the member's risk. Instead of electing to participate in DROP when he is first eligible to retire, the member can wait until he is ready to retire and then look back to see if he would have been better off had he elected DROP when first eligible to do so. The Back-DROP period still begins when the member first attained normal retirement age and ends 5 years later.

   The advantage of Back-DROP over DROP is that that there are no losers. A member determines after all the facts are known whether his benefit, calculated as if he had entered DROP at the proper time, is better than his benefit calculated without regard to DROP.

   Back-DROP provisions have an actuarial cost because the member cannot lose. There are no losers to offset winners. Larger benefits are paid than what would have been paid under a Traditional DROP program. Therefore, contribution requirements will be larger.

3. Retro-DROP

   Provisions we will call "Retro-DROP" not only eliminate the member's risk, but enhance his opportunity to maximize his benefit. Under Retro-DROP a member does not have to begin DROP at normal retirement eligibility, but may select any date thereafter. Moreover, he may select a DROP period of any duration up to 5 years.

   Retro-DROP allows a member to find the best combination of DROP entry and DROP exit dates during the period from the time he is first eligible for retirement to the date he actually leaves employment. And, he can make these decisions after all his service and salary credits have been determined.

   Retro-DROP provisions have an even larger actuarial cost than Back-DROP because a member has greater flexibility and can choose a benefit that is most advantageous to him.

The Firefighters' Retirement System in the city of New Orleans provides for both 5-year Traditional DROP and 5-year Retro-DROP. A member may participate in both. In other word, a member can retroactively select any five year period or less between his earliest retirement date and his termination of employment to participate in DROP. This gives the member significant flexibility in selecting a benefit calculation that provides him with the largest economic benefit. HB 458 expands that flexibility even further to allow the member to select any ten year period or less between retirement eligibility and employment termination.

At the end of the day, the 10-year Retro-DROP provisions under HB 458 will cost more actuarially than the 5-year Retro-DROP provisions under current law.

According to the January 1, 2009 actuarial valuation report, 17 firefighters ranging in age from 55 to 75 continue to work after exiting the current 5-year Traditional DROP program. Under current law:

1. These members do not contribute to the retirement system because they have attained normal retirement age.

2. The employer contributes to the retirement system for these members.

3. These members accrue a supplemental pension based on service credits and salaries earned after exiting DROP. But, for many, the accruals may be small because they have already attained the maximum permitted benefit of 100% x FAC.

4. When these members eventually leave employment, they can rescind their Traditional DROP participation and substitute the 5-year Retro-DROP rules. But, members with significant amounts of service will still have several years of employment during which they were collecting pay, earn a negligible benefit accrual, but did not receive a DROP deposit.

5. If HB 458 is enacted, these members could leave employment, rescind their original DROP participation, and substitute the 10-year Retro-DROP provisions. Using the 10-year rule, there will be very few years, if any, during retirement that the employee will neither accrue a benefit nor receive a DROP deposit.

The January 1, 2009 actuarial valuation reports 80 members who are currently participating in the Traditional 5-year DROP program. Experience has shown that many firefighters elect to continue to work even though they could retire and collect a pension benefit that is nearly the same as their working income. Enactment of 10-year Retro-DROP under HB 458 will ensure that a DROP deposit will be made for those years in which a member does not accrue additional pension benefits. Once again, 10-year Retro-DROP will cost more than the current 5-year Retro-DROP.

According to the January 1, 2009 valuation report, there are 93 members who elected not to enter the 5 year Traditional DROP program although they were eligible to do so. Instead, they have elected to continue to accrue service credits under the plan's benefit formula. These employees, under current law, still have the right to elect 5-year Traditional DROP and/or 5-year Retro-DROP. Enactment of 10-year Retro-DROP is likely to proved these members with a greater benefit upon termination of employment than the current 5-year Retro-DROP program. Greater benefits lead to an increase in actuarial costs.

In light of the above analysis, it is estimated that 20 members on average will receive a DROP deposit each year under 10-year Retro-DROP that would not have received a deposit under 5-year Retro-DROP. Therefore, assuming the average retirement benefit is $40,000, the annual cost of HB 458 is $800,000. The employer contribution rate will increase about 3.5% of pay from 60.9% of pay to 64.4%. The actuarial present value of this additional cost is estimated to be $10.7 million.

The Firefighters' Pension and Relief Fund contains two separately financed components – the Old Fund which covers firefighters employed before January 1, 1968 and the New Fund which covers firefighters' employed after January 1, 1968. The Old Fund is financed on a pay-as-you go basis. The new fund is actuarially funded. The funded ratios of the two component Funds are summarized below:

	Old Fund	**New Fund**
Market Value of Assets	$ 16.8 million	$ 160.0 million
Accrued Liability	168.2 million	298.9 million
Surplus/(Deficit)	(151.4) million	(138.9) million
Funded Ratio	11.1%	53.5%

Other Post Retirement Benefits

There are no actuarial costs or savings associated with HB 458 for other post employment benefits.

Analysis of Fiscal Costs

The fiscal implications of HB 455 over the next five years are summarized below.

1. Employer contributions (expenditures from Local Funds) will increase $800,000 a year (3.5%) to cover the cost of the increased benefits.

2. Retirement System expenditures on benefit payments (Agency Self Generated expenditures) will increase $800,000 a year.

3. Retirement System revenues (Agency Self Generated revenues) will increase $800,000 from employer contributions.

<u>Dual Referral</u>

Senate	**House**
[x] 13.5.1 ≥ $500,000 Annual Fiscal Cost	[ ] 6.8(F) ≥ $500,000 Annual Fiscal Cost
[ ] 13.5.2 ≥ $500,000 Annual Tax or Fee Change	[ ] 6.8(G) ≥ $500,000 Tax or Fee Increase or a Net Fee Decrease